

The IRS Is Knocking – Are You Ready?

Casualty Loss Reserve Seminar
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Acknowledgement

- The material presented herein is based on a presentation originally prepared and presented by my colleague, Ms. Susan Forray

Outline

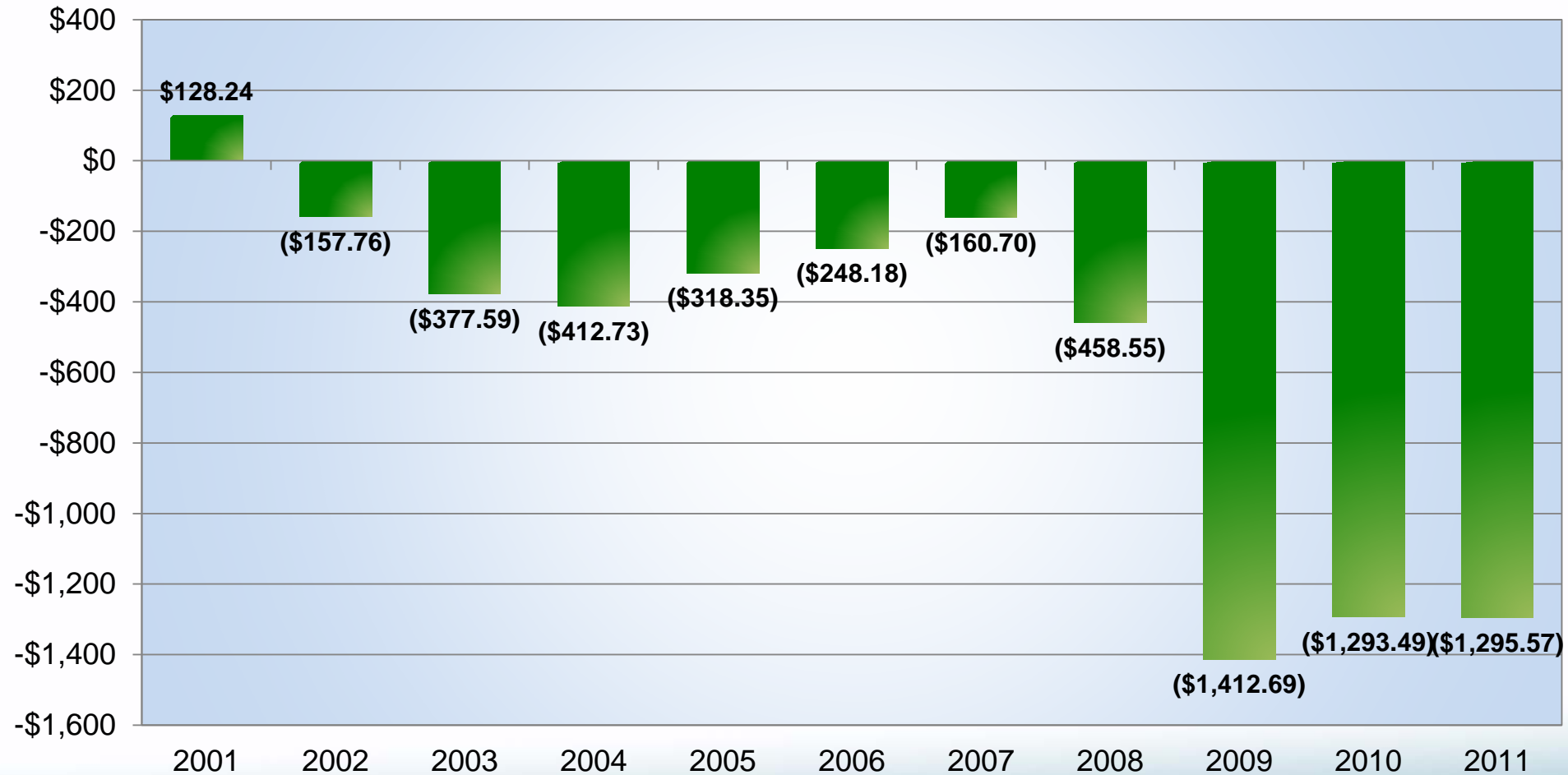
- Why the Insurance Industry?
 - Income
 - Loss Reserve Releases
- IRS Audits
 - Sources of Dispute
 - Audit Process
 - IRS Coordinated Issue Paper
 - Current Tax Court Cases
- Typical Characteristics of Audited Companies
- Summary Observations



A Discussion of Reserve Development

WHY THE INSURANCE INDUSTRY?

Federal Deficit (In Billions)

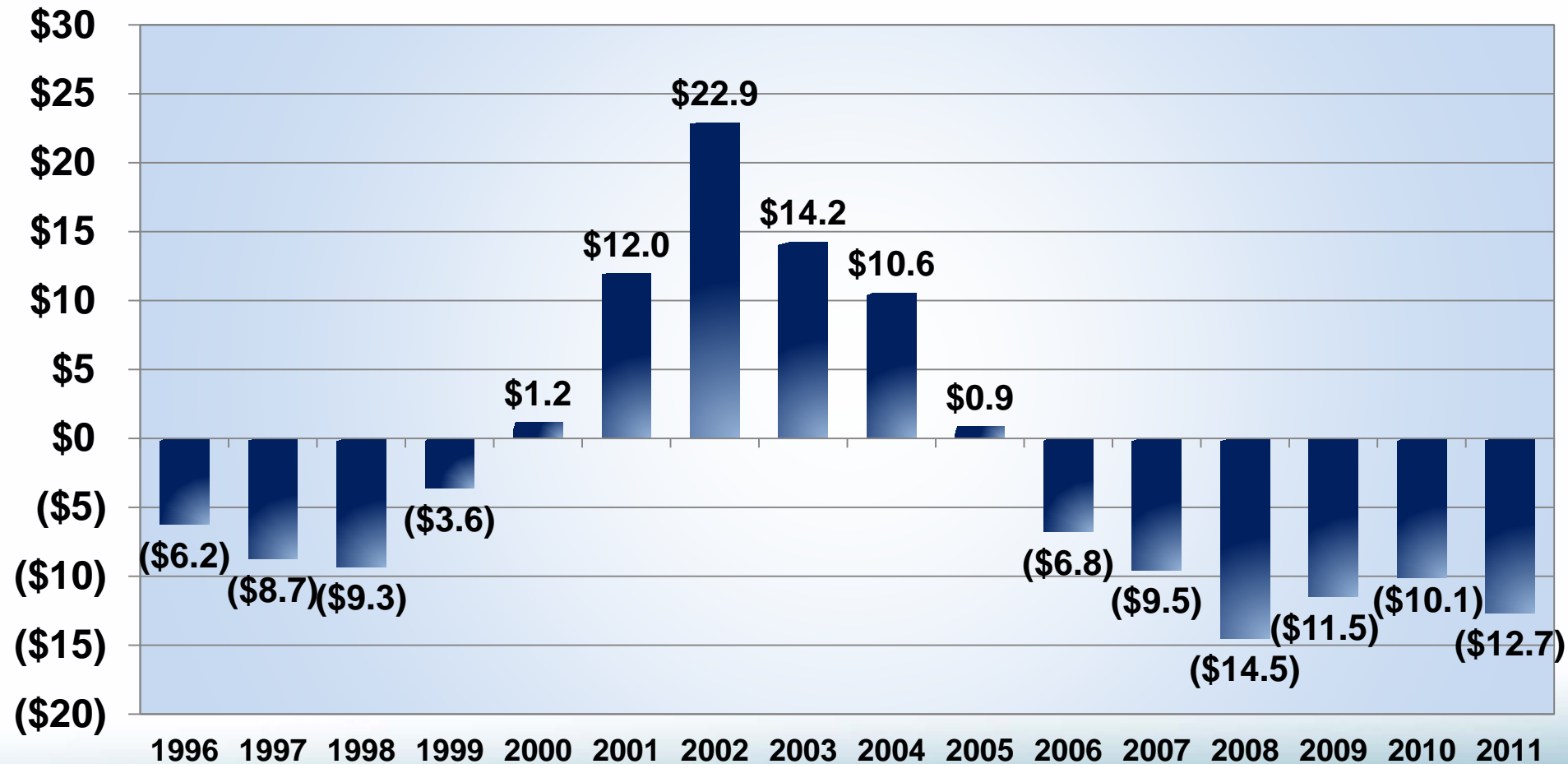


Source: Congressional Budget Office

Industry Reserve Development

Excluding Mortgage & Financial Guaranty

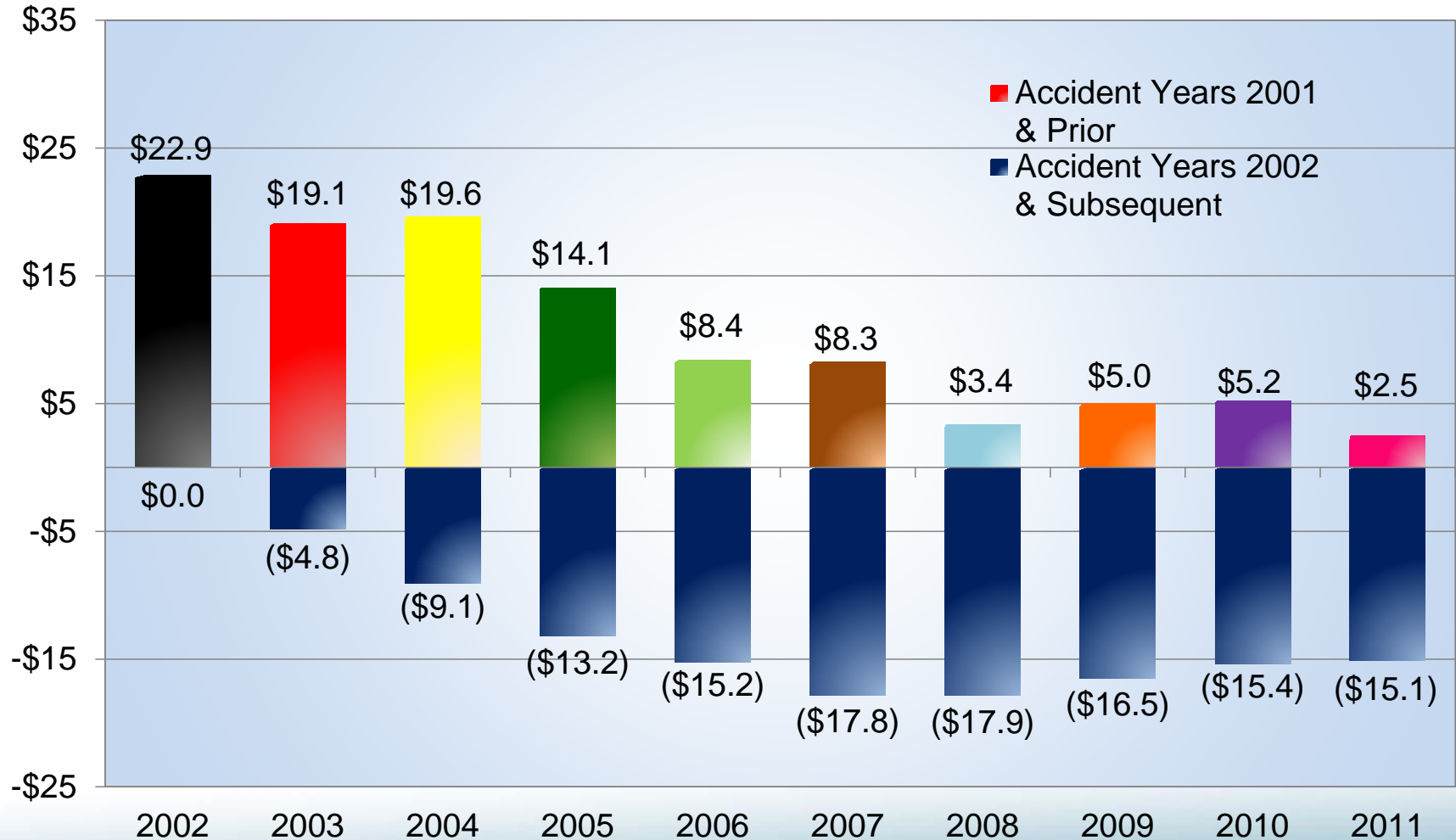
Net Loss & ALAE (In Billions), by Calendar Year



Source: Milliman analysis of Property & Casualty Statutory Annual Statements
Excludes Mortgage & Financial Guaranty

Industry Reserve Development

Net Loss & ALAE (In Billions), by Calendar Year
Split Between “Prior” and “Recent” Accident Years



Source: Milliman analysis of Property & Casualty Statutory Annual Statements
Excludes Mortgage & Financial Guaranty

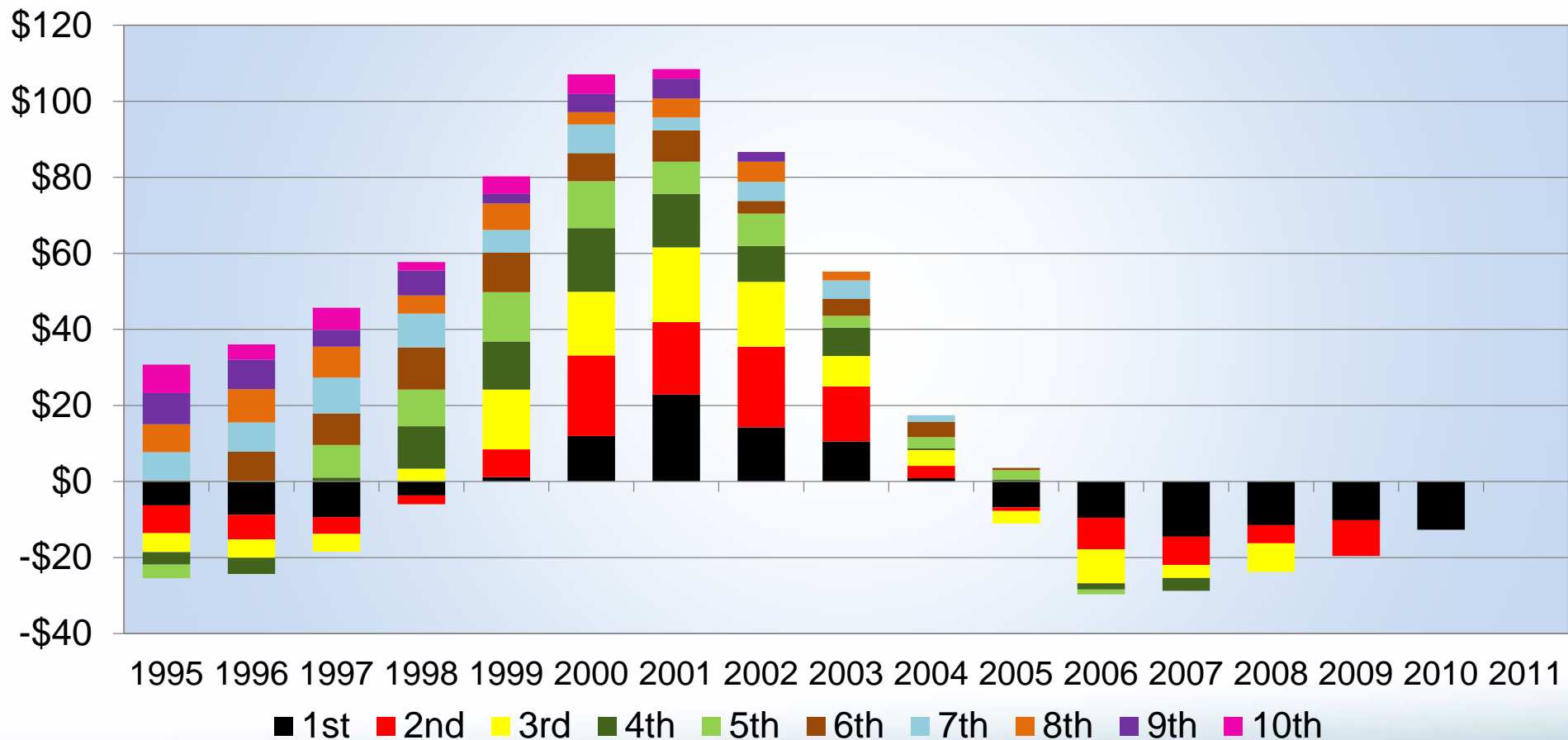


Candor. Insight. Results.

Statement Year Development

By Calendar Period, as of December 31, 2011

Net Loss & ALAE (In Billions)

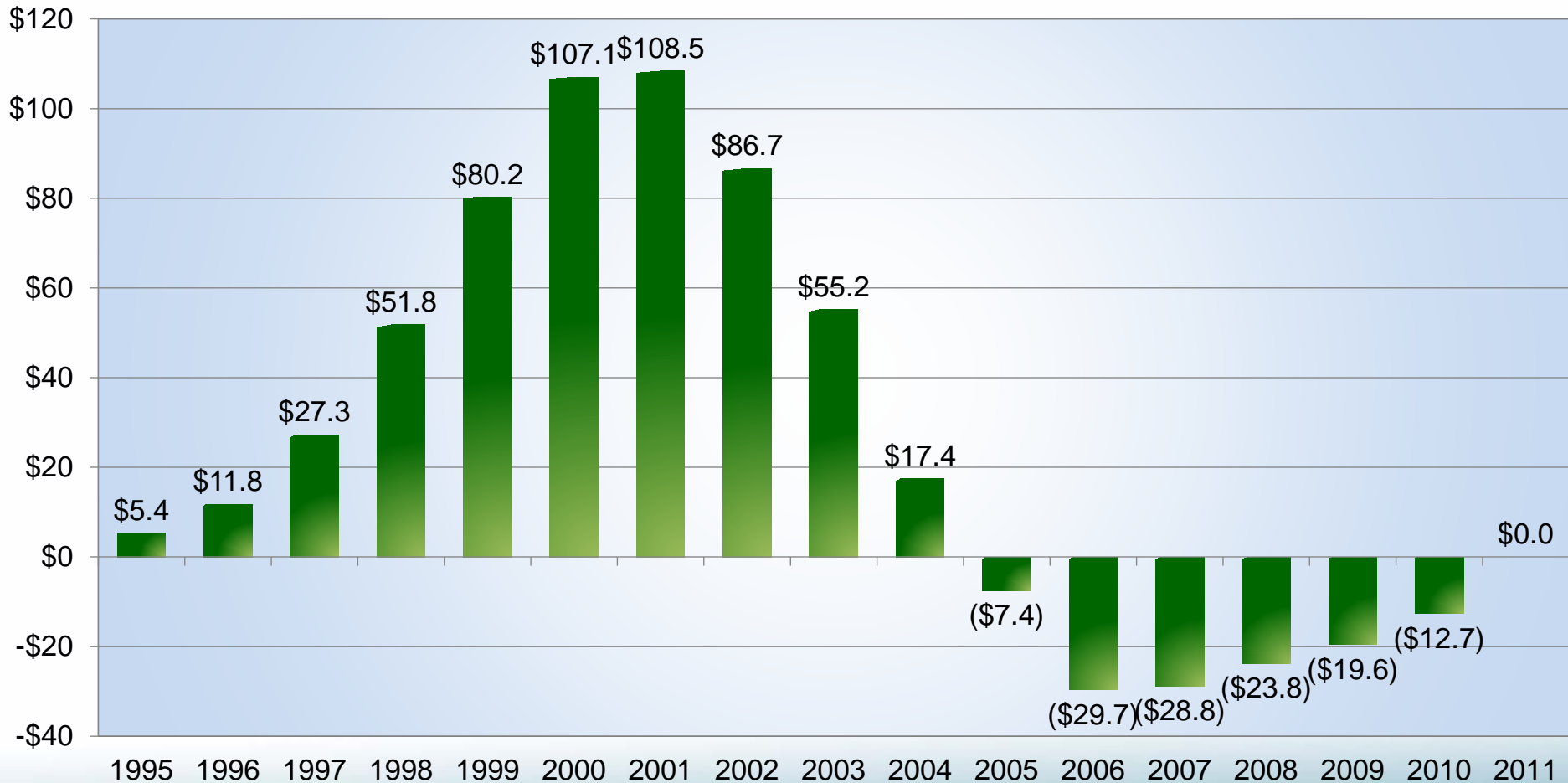


Source: Milliman analysis of Property & Casualty Statutory Annual Statements
Excludes Mortgage & Financial Guaranty

Development by Statement Year

Net Loss & ALAE (In Billions)

As of December 31, 2011



Source: Milliman analysis of Property & Casualty Statutory Annual Statements
Excludes Mortgage & Financial Guaranty

A Brief Background and Deeper Perspective on:
IRS AUDITS

Income Taxation of P&C Insurance Companies

- Classification as an insurance company
- General corporate tax rules apply
- Annual Statement is basis for income
- Discrete set of rules provided in Internal Revenue Code
 - Part I, IRC §801-818 – tax treatment of life insurance companies
 - Part II, IRC §831-835 – tax treatment of nonlife insurance companies
 - Part III, IRC §841-848 – provisions that apply to all insurance companies

Income Taxation of P&C Insurance Companies

- Premiums and related accounts
 - Claim of right doctrine
 - Deductions for increase in unearned premiums reduced by 20%
- Losses and related accounts
 - Reserves discounted by line of business by accident year
 - IRS prescribes discount factors annually
- Other adjustments
 - Salvage and subrogation
 - Investment income (dividends, capital gains, etc.)
 - Statutory exception to all-events test for certain liabilities

Sources of Dispute with IRS

- Status as insurance company
 - e.g., captives
 - “more than half” test must be satisfied
- Qualification of a policy as insurance or reinsurance
 - “Risk transfer” must be present
- Extracontractual obligations
 - *State Farm, 2011*
- Retiree medical benefits as LAE
- Dividends “paid or declared”
- Guarantee fund assessments

Sources of Dispute with IRS

- **Loss Reserves**
 - Easily the #1 source

Loss Reserves

- GAAP guidance

- **35-1** Changes in estimates of **claim** costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made. [FAS 060, paragraph 18]
- **35-2** As discussed in paragraph 944-40-30-2, estimated recoveries on unsettled claims, such as **salvage**, **subrogation**, or a potential ownership interest in real estate, shall be evaluated in terms of their estimated realizable value and deducted from the **liability for unpaid claims**. [FAS 060, paragraph 18]
- **35-3** As discussed in paragraph 944-40-30-3, estimated recoveries on settled claims other than mortgage guaranty and title insurance claims also shall be deducted from the liability for unpaid claims. [FAS 060, paragraph 18]
- **35-4** Subsequent reductions in the reported amount and realized gains and losses on the sale of real estate acquired in settling claims shall be recognized as an adjustment to claim costs incurred. [FAS 060, paragraph 19]

* Excerpted from FASB Codification section 944-40-35

Loss Reserves

- Statutory guidance
 - Changes in estimates of the liabilities for unpaid claims or losses and loss/claim adjustment expenses resulting from the continuous review process, including the consideration of differences between estimated and actual payments, shall be considered a change in estimate and shall be recorded in accordance with SSAP No. 3—Accounting Changes and Corrections of Errors (SSAP No. 3). SSAP No. 3 requires changes in estimates to be included in the statement of operations in the period the change becomes known. This guidance also applies to the period subsequent to the March 1 filing deadline for annual financial statements through the filing deadline of June 1 for audited annual financial statements.
- * Excerpted from FASB Codification section 944-40-35

What Does an Audit Look Like?

- Taxpayer receives notification from IRS that they will be audited for specific year(s)
- Opening conference is scheduled
 - Typically attended by taxpayer, IRS field examiner and taxpayer's representative
 - Discuss scope of audit and anticipated timing, contact information, timing of responses for Information Document Requests (IDRs) and Notices of Proposed Adjustments (NOPAs) and form and frequency of communication

What Does an Audit Look Like?

- IRS audit examination plan
 - Highlights year(s) being examined
 - IRS personnel
 - Examination schedule
- IDR
 - Requests for documents and records
 - Substantiation of information provided
 - General inquiries
- Fieldwork
 - Recommended to take place outside of taxpayer's office
 - Length will vary depending on circumstances of examination
 - IRS actuaries brought in as needed

What Does an Audit Look Like?

- NOPA drafted by field examiner
 - Lays out the issue, facts, law, taxpayer's position, discussion and conclusion
 - Can be presented throughout the audit process
- Responses to NOPAs
 - Agree
 - Agree in part
 - Disagree
 - Have additional information

What Does an Audit Look Like?

- Disagreed NOPAs
 - Generally, a meeting takes place between the field examiner, the IRS manager on the case, the taxpayer and the taxpayer's representative to arrive at an agreement
 - Can involve several meetings and discussions
 - IRS can agree to taxpayer's position due to additional facts or documentation, or keep the original adjustments
 - IRS is often willing to negotiate if several NOPAs remain open at the end of an audit

What Does an Audit Look Like?

- Closing meeting
 - Attended by all parties
 - Negotiations are finalized
 - Closing agreements discussed and issued
- Next step: Appeals vs. Fast track settlement
- Don't like Appeals' offer?
 - Appeals mediation
 - Litigation

IRS Coordinated Issue Paper

- Annual Statement a “general guide”
- Statutory accounting “favors conservatism”; tax rules do not
- Conclusion:
 - “For federal income tax purposes, estimates of insurance company unpaid losses must be fair and reasonable in amount and must represent actual unpaid losses. Margins or other additions to unpaid losses that are not based upon the company’s actual loss experience cannot be included in the deduction for losses incurred. If a taxpayer cannot establish that a margin or other addition to unpaid losses represents actual unpaid losses, the deduction will be disallowed to the extent it exceeds a fair and reasonable estimate.”
- <http://www.irs.gov/businesses/article/0,,id=215618,00.html>

Current Tax Court Cases

Acuity Insurance Company

- Filed April 2011
- Scheduled for trial September 4, 2012
- Single issue: loss reserves
 - \$100 million proposed adjustment
- IRS to use two outside actuarial experts
- IRS conceded guarantee fund issue

Current Tax Court Cases

Sentry Insurance Company

- Filed July 2011
- Not yet scheduled for trial
- Issues
 - Loss reserves
 - Accounting for acquisition
 - Income as state work comp servicing carrier
 - Multi-year contracts
 - Uncollectible reinsurance

Property & Casualty Industry – Audited Companies

TYPICAL CHARACTERISTICS

Typical Characteristics

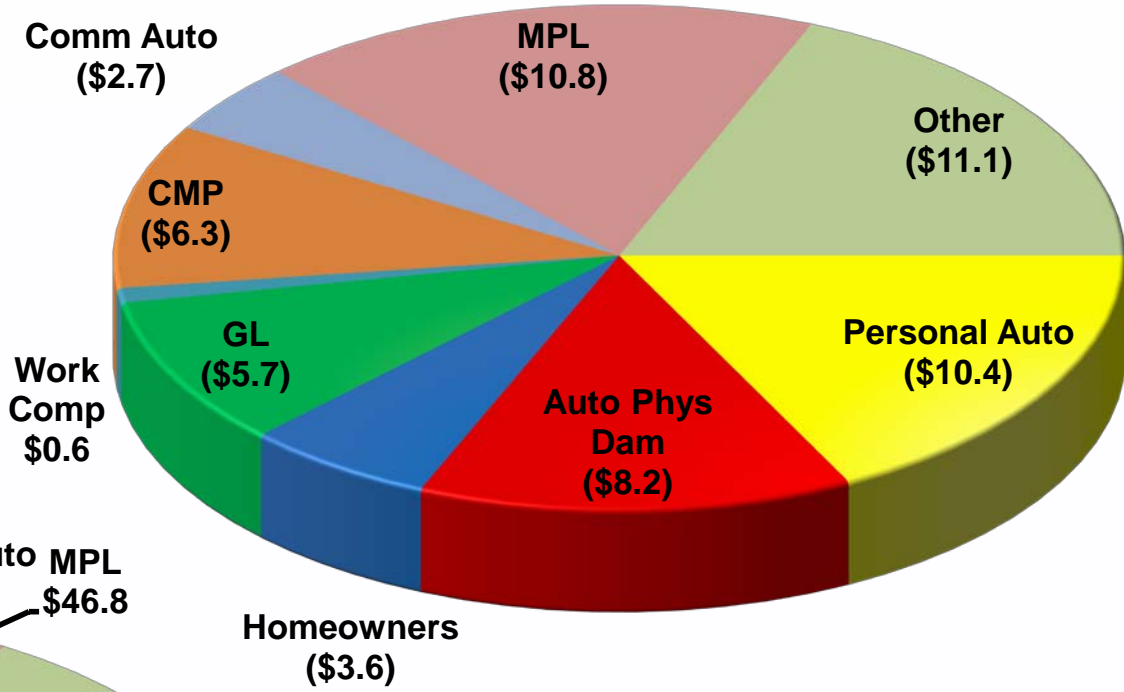
- Well run, financially sound
 - “A” rated or better
- Often mutual insurers
- Size threshold
 - \$100 million+ net earned premium
- Both multi-line and mono-line writers

Line of Business

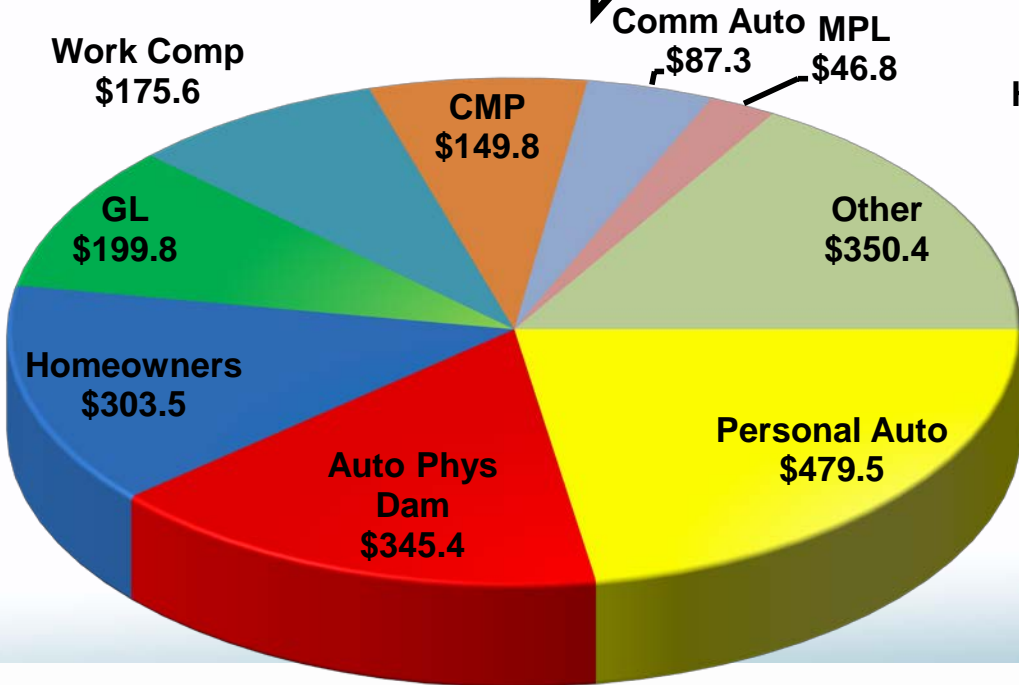
2007 – 2011

(Net, In Billions)

**Reserve
Development**



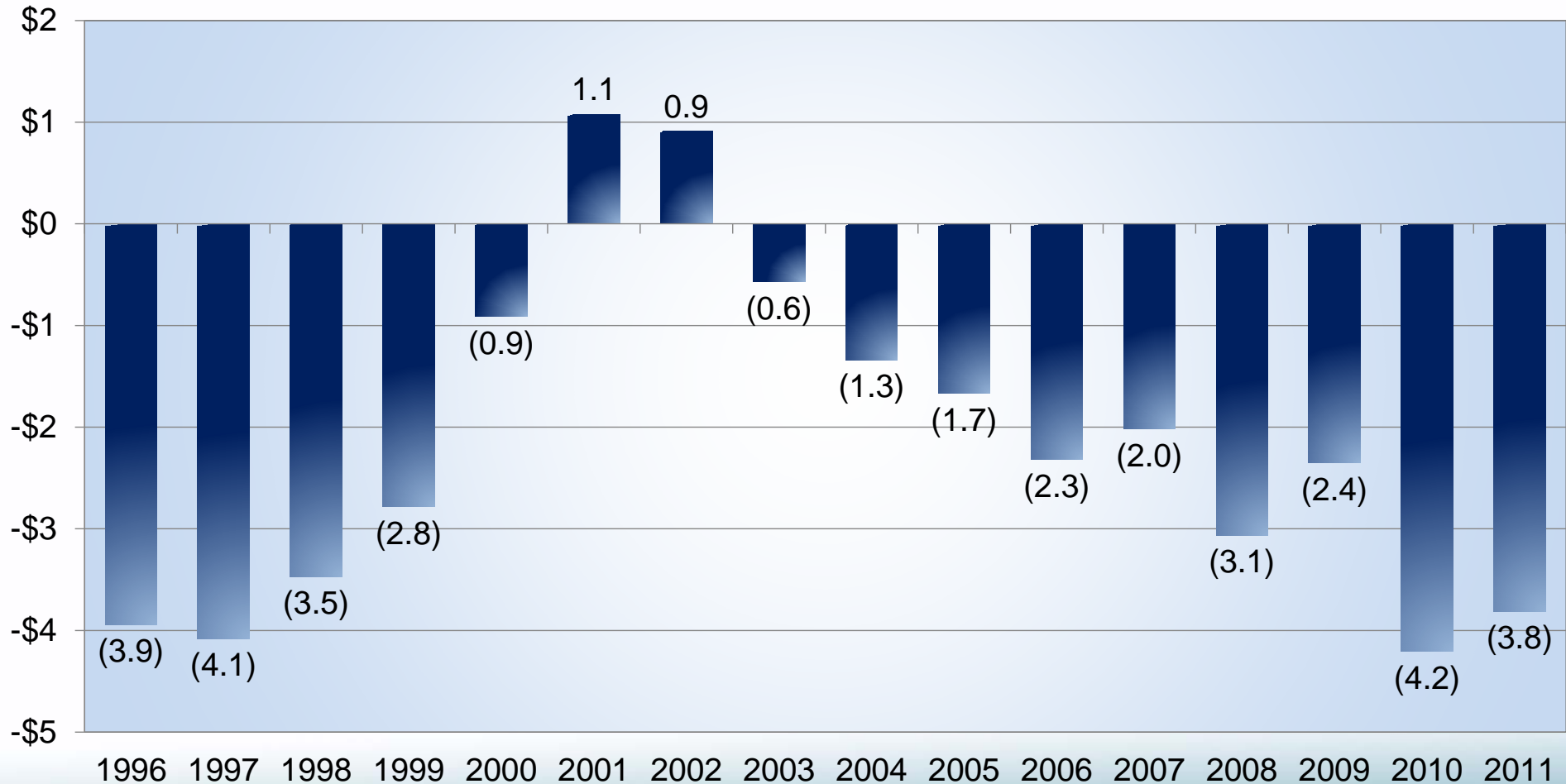
**Earned
Premium**



Mutual Companies Only

Calendar Year Reserve Development

Net Loss and ALAE, In Billions

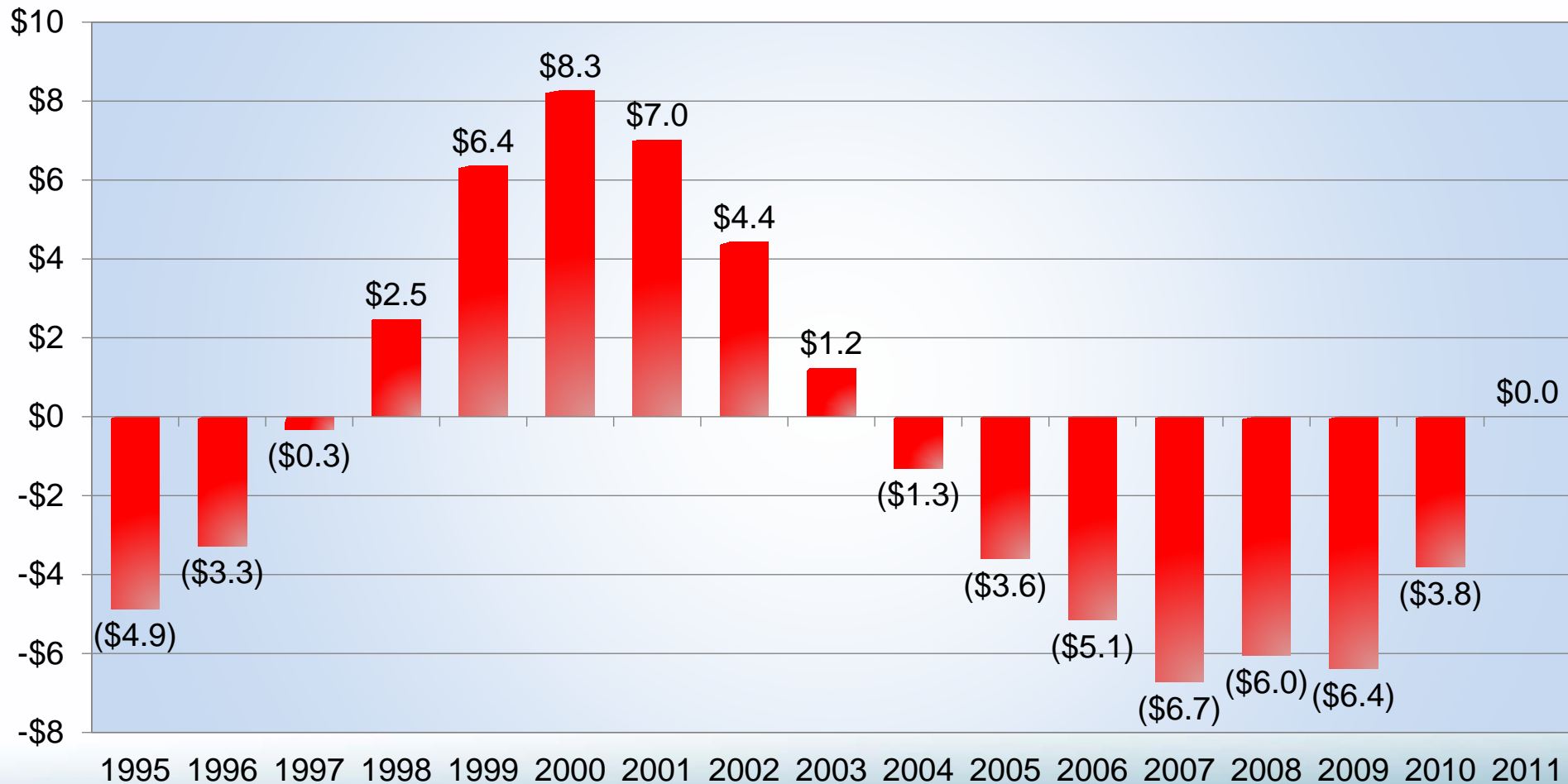


Source: Milliman analysis of Property & Casualty Statutory Annual Statements
Excludes Mortgage & Financial Guaranty

Mutual Companies Only

Statement Year Reserve Development

Net Loss and ALAE, In Billions, as of December 31, 2011



Source: Milliman analysis of Property & Casualty Statutory Annual Statements
Excludes Mortgage & Financial Guaranty

SUMMARY OBSERVATIONS

Summary Observations

- P&C Industry May Not Be Over-Reserved
 - In hindsight, 1995 – 2004 statement years under-reserved
 - 2005 & subsequent statement years
 - Have run off favorably to date
 - But may develop adversely due to tail liabilities
- Typical Characteristics of Audited Companies
 - Mutual structure
 - Financially sound
 - Medical professional liability (often)
 - Reserves audited selectively



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- **The Casualty Actuarial Society is committed to adhering strictly to the letter and spirit of the antitrust laws. Seminars conducted under the auspices of the CAS are designed solely to provide a forum for the expression of various points of view on topics described in the programs or agendas for such meetings.**
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